

# INSIDE SUPPLY MANAGEMENT

## Features

### Protect Against Procurement Fraud

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#### **With commitment from organizational leaders and supply chain due diligence, organizations can avoid the devastating effects of fraud.**

The nationalization and globalization of supply chains have left them more vulnerable to various forms of risk, especially those related to procurement fraud. Unfortunately, too many organizations have equated a contract with compliance. In those cases, organizations have found themselves in the unenviable position of dealing with product recalls and liabilities from consumer injuries due to lapses in the procurement process. As supply chains stretch further beyond immediate reach, organizations must avoid taking a laissez-faire attitude toward ensuring consistent quality throughout. While U.S. companies may look to point fingers across the oceans, it is fair to say that we are to blame for our own complacency and the problems it has caused.

#### Characteristics of Procurement Fraud

What qualifies as procurement fraud? These activities include bribes and kickbacks to cover up falsified pricing, product substitutions, substandard quality issues, anticompetitive policy violations, counterfeit goods and the occasional shell companies that involve an employee and sometimes a close outside collaborator. Such frauds can focus on the acquisition of raw materials, services, finished goods and components. Perpetrators of procurement fraud include the internal buyer, external supplier or rogue employee with enough authority to approve purchases and, possibly, invoice payments. However, organizational failure at the senior management level is also a factor.

Procurement fraud affects the entire supply chain and those partners that are relied upon as suppliers and customers. The holistic view of the supply chain does not necessarily distinguish between activities that happen internally or externally, however. Even with the increased outsourcing of various functions and operations, more supply chain activities tend to occur within an organization than on the outside.

Thus, the definition between a supplier and a customer can tend to blur. Examples of internal supplier—customer relationships include relationships among the receiving dock, quality assurance (QA), inventory

control, manufacturing, sales order processing, accounting and distribution. This is important to note because the discussion of procurement fraud should not distinguish between internal and external relationships. Procurement fraud can be perpetrated both inside and outside an organization; the perpetrators can be internal, external or a combination of both.

### Classifying Procurement Fraud

The next question, however, is whether a fraud should be classified as occupational or organizational. The answer could have major implications for all employees. The following describes the distinction between the two classifications.

**Occupational fraud.** The utilization of a person's job role — which may include their rights and roles in a business software application, such as an ERP system — is considered to be occupational fraud. A person does not need to be in a position of high—level authority, such as a senior executive. The occupational fraud perpetrator may have sufficient ERP rights and roles in a staff or managerial position with sufficient authority to carry out fraud, especially if controls are weak or easy to avoid.

**Organizational fraud.** Frauds perpetrated by senior executives, especially in collaboration, are generally considered to be organizational in nature. While unlikely that all an organization's employees would be involved in the fraud, the fact that senior leadership steered the organization in such a direction makes the organization itself corrupt. What is more unfortunate about the impact of organizational versus occupational frauds is that organizational frauds can cause the collapse of the organization itself, leaving otherwise honest employees jobless.

The distinction between frauds perpetrated at the occupational versus organizational levels can be important when determining culpability for violations of Sarbanes—Oxley. A key aspect of the Committee of Sponsoring Organizations (COSO) compliance framework is the Control Environment. Also known as the "tone at the top," the Control Environment is defined by executive management's decisions and actions. Penalties for compliance infractions for "corrupt organizations" can be more severe than those where rogue employees were singularly bent on adverse behavior despite the organization's (best) efforts to mitigate such disruptive actions.

### Necessities: Quality Assurance and Traceability

Because the links of the supply chain are interconnected, procurement frauds can have a ripple effect and manifest themselves differently than they originated. What may have started as a seemingly innocuous fraud can have a devastating end result. Fraud perpetrators don't normally think about the ramifications of their actions versus the gains.

This is why QA and traceability are so important. Knowing the source of raw materials and components, at what point they are injected into the supply chain and to which customers (and where) finished goods are shipped lays the foundation for establishing what is analogous to a chain of evidence that can be used to trace a problem back to the procurement source. If it is necessary to react to a quality defect, tracing the source of the raw materials is of critical importance. There is no distinguishing between internal and external sources. Regardless of where a supply chain link acquires the input of inbound materials, knowing and recording the source and other relevant data is of critical importance to back—tracing if a problem occurs.

### Strategies to Mitigate Fraud Risks

When establishing a strategy for reducing procurement fraud, organizations must look at both internal and external procurement sources and link properly funded QA oversight to procurement acceptance. The following includes strategies to employ to mitigate procurement fraud and its impacts:

The Association of Certified Fraud Examiners recognizes that the separation of responsibilities is a proven

fraud—reduction tactic. Do not mix your procurement and QA programs under the same first—level and probably second—level management. After establishing internal procurement and quality department guidelines for excellence, ensure these two critical, independent departments share data and assist each other in reducing procurement frauds and improving the overall integrity of the procurement process throughout the internal and external supply chain.

The procurement cycle takes on added integrity when the purchase order and accounting processes are included in the data—sharing process — for example, make sure you receive what you ordered and that you only pay for first—quality goods.

Senior executive management must set the right tone at the top and place the health and safety of the organization's customers and employees — the long—term gains — above short—term financial rewards. The message is that cutting corners and having unattainable benchmarks are unacceptable.

Know your suppliers and know them well ... including their possible relationships to employees.

— *Full disclosure*: Make sure your supplier and employee guidelines state that employees and suppliers (potential and existing) will immediately fully disclose relationships.

— *Relative distance*: Make sure your employee guidelines clearly state that upon full disclosure, an employee will distance himself or herself from the decision—making process used to select a supplier or continue using a supplier.

Use horizontal and vertical analysis with common sense. Are you ordering too much or too frequently? Audit prices to ensure they are in line with industry averages. This is not about finding the cheapest source but ensuring you are fairly paying for quality goods and services.

Track returns and failures to their source. Ensure supply sources are held financially accountable for failures which may be due to quality issues related to fraudulent activities internally, externally or both.

Reducing procurement fraud starts with a commitment at the top, supported by integrated systems that cut across and bridge the data gaps between many operational departments, as represented by the holistic supply chain. The COSO and the control objectives for information and related technology (COBIT) Sarbanes—Oxley compliance frameworks provide excellent guidance for the establishment of monitored internal controls and business—application security for public companies, private enterprises and government agencies alike. Place a commitment to quality above short—term results, and don't let politics force internal pressures to take precedent.

For more information on supply chain fraud, visit [www.supplychainfraud.com](http://www.supplychainfraud.com).

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*For more information, send an e—mail to [author@ism.ws](mailto:author@ism.ws).*

## CASE STUDY: Tainted Pet Food

**W**hile there have been several fraudulent cases (for example, lead in toys, tainted peanuts and the like), the tainted pet-food scandal was particularly upsetting because of how much people love their pets. We seem to react to tragedies differently depending on the victim's characteristics (for example, a child versus adult, teenager versus senior citizen, nondomesticated animals versus pets). To recap what occurred: In 2007, a manufacturer in China tainted pet food with melamine to boost the protein level of the product. A government inspector was provided money to look the other way. Before pointing the finger of shame and blame at China, however, let's follow the pet food's path through the rest of the supply chain.

The tainted product was shipped from China to Canada, where it was packaged (private-labeled) before distribution into the United States. Certainly the events in China were fraudulent: Persons in specific occupations went rogue and perpetrated deceptive — if not illegal — actions for their own gain. While organizations cannot fully prevent an employee from going rogue, there are procedures that should be in place (at the supplier site, as well) to minimize the collateral damages.

The major question is why didn't QA programs, as part of the overall procurement process, catch the tainted pet-food product in Canada? As it passed into the United States, why wasn't it screened there? It begs the question of whether QA programs were active in Canada and the United States to begin with. Let's explore a few possibilities that could have occurred at the Canadian packaging company or the various U.S. food-product companies:

1) **No QA program existed.** This may be a regulatory violation if the U.S. Food and Drug Administration or its Canadian counterpart has jurisdiction over pet food. However, if there was no legal requirement, perhaps neither company felt the need to pursue such monitoring. While it may be legal to not monitor for quality, was it an ethical or right thing to do, especially knowing the results of such quality failures?

2) **The QA program was tainted.** It's possible that people inside the organizations in Canada and/or the United States were:

- Receiving bribes — probably from an external source — to pass tainted product through tests or falsify test results.
- Under threat of violent harm.

3) **The QA program was rendered ineffective:**

- The fact that QA is performed does not imply that it is conducting all necessary tests and that a proper statistical sampling is being examined. This is possibly due to ineffective management or limitation of resources.
- Was senior executive management failing to properly fund and provide the necessary resources for an effective QA program? If this was a failure by senior management, was it done to boost profit margins by reducing operating expenses?
- QA staff may be under duress from threat of job loss due to pressure from internal management to increase throughput without receiving the necessary equipment or personnel. Again, were necessary resources and dollars withheld to make budget goals or financial expectations?

To avoid a devastating fraudulent event, senior management must establish a whistleblower hotline where employees can anonymously report breaches in policy and procedure, especially those that could result in the production of harmful products. While employees may be fearful for their jobs and the operational impacts, organizations may be relying on a few courageous employees to stand up and report abuse when they see that fraudulent activities exist. In some industries, it may be preferable to educate employees on how to contact the government regulatory agencies that would have jurisdiction (for example, the Food and Drug Administration, Consumer Product Safety Commission and Environmental Protection Agency).

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